Center for Insurance Research

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October 12, 2012

The Honorable Senator Joe Hune
Chairman, Senate Insurance Committee
P.O. Box 30036
Lansing, MI 48909-7536

Dear Chairman Hune:

We are writing to you and your committee to oppose the proposal to reorganize Blue Cross Blue Shield of Michigan (BCBSMI) from a public charitable organization into a mutual insurer owned by its policyholders (albeit a tax paying nonprofit) under the terms articulated by Governor Rick Snyder and BCBSMI and to urge the Legislature to slow down the consideration process to allow for proper deliberation on this highly complex matter. Remarkably, no specific legislation has yet been made public at this late date despite a scheduled hearing on October 16, 2012, shortly after which proponents expect immediate adoption of their bill.[1] Therefore, we address the positions that have been publicly articulated by the proponents.

The Center for Insurance Research (CIR) is a nonprofit, public policy and advocacy organization founded in 1991 that represents consumers on insurance matters nationally. CIR has extensive experience with mutual insurers, including in analyzing and policing complex transactions such as mergers, reorganizations and conversions. CIR has also analyzed and commented on other proposed Blue Cross/Blue Shield conversions in the past.

Proponents of the BCBSMI reorganization make several arguments to support the conversion itself and the emergency legislative approval process. We address the most salient points in our analysis below:

First, proponents claim that the proposed reorganization is not a "conversion" because BCBSMI will merely be changing into a nonprofit mutual corporation and not into a for-profit corporation owned by stockholders. Thus, they argue, the nonprofit mission of BCBSMI will be unchanged.

Response: This argument ignores the fact that BCBSMI will fundamentally alter its ownership structure, converting from a nonprofit charitable organization, with charitable purposes and obligations in service to taxpayers, *into a private corporation with private owners* (the policyholders, 1.1 million of which do not even live in Michigan). In fact,

[1] Two bills have been introduced (S. 1293 and 1294), but evidently only as placeholders given that they do not address most aspects of the proposed transaction.

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the proponents admit that "Ownership of a mutual resides with its policyholders whose voting power is established in the bylaws." BCBSMI Briefing Materials at page 5. Profits from the mutual will accrue to the benefit of those new owners (and not to the public). Therefore, it is a conversion of ownership in the most traditional sense.

Moreover, the nonprofit designation is without meaning since all mutual insurers are supposed to provide "insurance at cost" and operate without a traditional profit motive (and BCBSMI will pay state and federal taxes). The purpose of the mutual will be to serve the interests of its policyholder-owners.[2] This structure also begs important questions: who will actually control the insurer (proponents suggest policyholders will have voting rights), who has the authority to enforce its charter, who benefits from its financial success (such as dividends) and what rights will policyholders possess with regards to future operations and potential corporate changes (*i.e.* mergers, conversions or other). The more the hybrid mutual is structured to protect the public mission, the more the policyholders' rights will have to be suppressed. Our experience is that when policyholders are disenfranchised, the more insular and powerful the management becomes, making the insurer vulnerable to abuse and a loss of mission while leaving citizens and policyholders alike reliant on overworked and underfunded state regulators.[3]

Second, proponents claim that, because it is not a conversion, no appraisal is required to value the public's interest in BCBSMI to ensure that the taxpayers are fully compensated for their past contributions as part of the reorganization. Therefore, they argue that the proposal for BCBSMI to pay $1.5 billion over 18 years (or $83 million/year) is fair because it amounts to nearly half of the company's reserves. Moreover, they argue that the company cannot afford to pay more because it needs the reserves to continue operating.

Response: When a charitable asset is transferred to a private corporation with private owners, the public's value must be appraised and paid to an entity with an ongoing charitable purpose. *Otherwise the new entity will be unjustly enriched by the public's*

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[2] *See, e.g., Penn Mutual v. Lederer*, 252 U.S. 523, 40 S.Ct. 397 (1920) at 525, 398 ("It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policy holder."); 533, 400 (mutual insurers act wholly for the benefit of their policyholders and are co-operative enterprises); 535, 401 (policyholders are the members of a mutual and elect the board of directors).

[3] An example of just such a nonprofit mutual is The Beacon Mutual Insurance Company, which was created and capitalized by the Rhode Island legislature, with a public mission and gubernatorial-appointed directors, and yet devolved into a bastion of favoritism, corruption and incompetence while state oversight was lacking for years and policyholders were overcharged and mistreated. A belated regulatory examination documents in 312 pages Beacon Mutual's pervasive misdeeds and breaches of duty. *See* http://www.dbr.state.ri.us/documents/divisions/insurance/examinations/Beacon_Mutual-4-20-07.pdf

assets, which were built up by taxpayers' historic subsidy of BCBSMI since its founding in 1939.

Moreover, the value of BCBSMI today far exceeds the present value of the $1.5 billion-over-18-year payment (which is far less than $1.5 billion). In fact, it had subscribers' reserves of $3.2 billion at the end of 2011, which was up $300 million from the $2.9 billion reported in 2010. *See* www.bcbsm.com/home/bcbsm/annual_report.shtml. These subscribers' reserves represent the mere "book value" of the company (its assets above liabilities), and the fair market value of this profitable ongoing concern is obviously much higher than $3.2 billion as discussed below.

Third, proponents argue that the $83 million per year to be paid to a charitable entity over 18 years will be used to promote "healthy lifestyles, provide better access to health care and improve public health," according to the Governor, thereby fully continuing the company's mission to Michigan more generally.

Response: As noted above, BCBSMI had a book value of $3.2 billion (subscribers' reserves) at the end of 2011. Its market value could well exceed twice that amount or $6.4 billion, particularly given its market dominance. Obviously, paying $1.5 million over 18 years is far less valuable and, in fact, has a present value of only $902 million based on BCBSMI's current rate of return on investments.[4] Clearly, this sum falls far short of the fair market value of BCBSMI.

Proponents have never addressed this inconsistency, except to argue a *non sequitur* that BCBSMI needs the capital to operate. There are mechanisms for financing a fair payment to Michigan *without* limiting BCBSMI's ability to operate. For example, mutual insurers are often started with outside capital, called guarantee stock, which is either paid off over time as the mutual can afford to do so and/or receives dividends on the mutual's profits on an ongoing basis. The charitable entity to be created could own the guarantee stock for the fair market value of BCBSMI, and receive dividends and/or interest payments. Thus, an ongoing stream of payments (not limited to 18 years) could be used to promote "healthy lifestyles, provide better access to health care and improve public health," and would be done without giving away Michigan's financial interest in BCBSMI as is currently proposed. In addition, other financing mechanisms exist, including the issuance of surplus notes (subordinated debt that is treated as subscribers' reserves) that could finance payments to the new charitable entity and/or become the mechanism by which the new charitable entity receives regular payments.

Fourth, proponents argue that BCBSMI will pay an estimated $100 million in state and local taxes, which will level the playing field with competitor health insurers.

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[4] Using a 6% discount rate (*i.e.* its actual rate of return), the actual present value of $1.5 billion is approximately $902 million. *See* http://news.bcbsm.com/news/2012/news_2012-03-02-14000.shtml ("BCBSM once again outperformed national benchmarks when managing its investments, achieving rates of return averaging just over 6 percent.")

Response: While leveling the playing field is appropriate, these funds would go to Michigan's general fund (and local government), thus pulling these dollars out of health care. Premiums will have to rise to cover the discrepancy. The payment of $83 million a year for 18 years to a nonprofit entity under the proposal would similarly have to be paid for. Proponents never address this aspect of the reorganization, nor the added costs of the conversion itself, which could be substantial.

Fifth, Kevin Clinton, commissioner of the Office of Financial and Insurance Regulation, was quoted in the press that safeguards would have to be instituted to make sure the mutual stays in Michigan and is not sold, demutualized (converted to stock form) or merged away – at which point the fair market value of the mutual would be transferred to the new charitable entity, he said.[5]

Response: Ensuring that BCBSMI stays in Michigan is critical. However, the stated remedy will not protect against future changes to the as yet unknown statutes (which happen with frequency once the limelight is faded years down the road). It also disenfranchises the mutual policyholders who will contribute to the reserves of the company after its mutualization (which is unfair to those policyholders). The time to value Michigan's interest is now, before the policyholders' begin making contributions to build up the mutual's future reserves through their premiums. Thus, while Mr. Clinton's proposed safeguards implicitly acknowledge that the mutual has a fair market value that it is far in excess of the proposed 18 year payment (with a present value far less than $1.5 billion), his approach inappropriately postpones the time for assessing Michigan's charitable asset, and thus we believe would disenfranchise the policyholders (and/or invite future claims that Michigan's interests has been diluted). The policyholders must be protected against this misuse of the mutual as an empty corporate shell.

Sixth, proponents argue that the legislature should expedite the review process of the legislation (still publicly undisclosed) because the federal Affordable Care Act will make its products unsuitable and because its long (18 month) rate review process will allow its competitors to unfairly obtain its proposed rates and under-price BCBSMI's products.

Response: The stated concerns about the slow or disparate rate regulation that currently applies to BCBSMI suggest their own remedy - rate reform. There is nothing about BCBSMI's nonprofit charitable status that would prevent rate regulation from being applied to it on equal terms as all other insurers, and it could be assessed state taxes or agree to make payment in lieu of taxes (PILOT) payments as a result of its changed obligations and opportunities due to the ACA. In fact, of the dozen or so nonprofit charitable Blue Cross/Blue Shield organizations around the country, <u>only</u> BCBSMI is claiming that the Affordable Care Act and rate regulation necessitates that it convert to a mutual (or any other form).

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[5] *See* http://www.mlive.com/business/index.ssf/2012/09/legislature_pushes_forward_wit.html

Seventh, Commissioner Clinton was quoted as stating that rates will likely go up for certain people after the transition, but that they would be a result of the Affordable Care Act and not Blue Cross's new structure. The Blues transition, Clinton said, should actually level the playing field and create more competition among insurers since the company would have to start paying taxes. It currently takes about 18 months for Blue Cross to get rates approved by the state. That would shrink to about two or three months under the new plan, which is typical for other insurers.[6]

Response: In reality, the Affordable Care Act will make the rate regulation much simpler for all insurers, including BCBSMI and having nothing to do with a conversion. Clearly, whether and why rates may increase deserves a substantial and concerted focus by the legislature before adopting conversion legislation. Among other things, paying $100 million in taxes plus $83 million to the charitable entity annually will have to be accounted for.

For the foregoing reasons, the conversion of BCBSMI into a mutual insurer is unsound as proposed and unjustified on an expedited basis. There are a myriad of issues that must be addressed to ensure it is justified, fair and in the interest of Michigan and its residents, and the current proposal satisfies none of these criteria.

Please let us know if we can provide you and the Committee with any further assistance on this important matter.

Sincerely,

Brendan Bridgeland
Director

[6] *See* http://www.mlive.com/business/index.ssf/2012/09/legislature_pushes_forward_wit.html

Michigan Consumers for Healthcare

Getting the BCBSM Conversion Right Will Take Time and Require Independent Analysis

Slow Down and Get the Facts:

- An independent insurance research institute, the Center for Insurance Research, has concluded the current BCBSM conversion framework constitutes a billion dollar "giveaway" of Michigan's charitable community assets

- Federal officials have confirmed that there is no need for BCBSM to change its corporate status in response to the Affordable Care Act. Consequently, there is no urgency that would justify the Legislature abruptly ending stakeholder participation or interfering with an independent fair market valuation of BCBSM assets.

- There is an enormous difference between "book value" and "fair market value" and basing a charitable liability estimate for BCBSM on book value, as this proposal does, would cost Michigan potentially billions of dollars in lost community charitable assets built up with taxpayer subsidies since 1939.

- History shows that states that fail to conduct fair market valuation studies at the time of conversion end up settling for pennies-on-the-dollar-- an error in judgment that could again cost Michigan citizens billions in lost charitable assets.

- This proposal offers no new rate-setting protections for consumers despite the fact that the proposal essentially deregulates a functional monopoly that controls 70% of the insurance market in Michigan.

- A Community Health Impact study is needed to identify unintended consequences to public health in Michigan due to this proposal. For example, this proposal, as written, would make it possible for all Michigan insurers, including BCBSM, to eventually deny secondary Medicare Medigap coverage to all older adults and persons with disabilities with pre-existing conditions. (Note: the ACA "must-issue" provisions don't apply to secondary insurance like Medigap.)

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